

AR14



PALOMA PETROLEUM LTD.
ANNUAL REPORT 1979



CORPORATE INFORMATION

Directors:

Walter J. Adams, Calgary, Alberta
G. Clarence Elliott, Winnipeg, Manitoba
W. Roy Jennings, Calgary, Alberta
John E. Stobart, Calgary, Alberta

Officers:

Walter J. Adams, Chairman of the Board
John E. Stobart, President
John J. Nadurak, Vice-President — Operations
Brian J. Waters, Vice-President — Engineering
Gordon W. Meggison, Secretary-Treasurer

Head Office:

1150 Guinness House
727 - 7 Avenue S.W.
Calgary, Alberta
T2P 0Z7

**Transfer Agent and
Registrar:**

Montreal Trust Company
Calgary, Montreal, Toronto,
Vancouver

Legal Counsel:

McLaws & Company
Calgary, Alberta

Auditors:

Peat, Marwick, Mitchell & Co.
Calgary, Alberta

Bankers:

The Toronto Dominion Bank,
Main Branch, Calgary
Canadian Commercial &
Industrial Bank, Calgary

Subsidiary Companies:

Compass Investments of
Alberta Limited
Compass Resources Ltd.
Conquest Oil & Mining Ltd.
Conquest Resources, Inc.
Grenville Exploration Limited
Paloma Petroleums, Inc.

Annual Meeting

The Annual General Meeting
of the Shareholders will be
held on May 12, 1980 in
Salon A and B, Holiday Inn,
708 - 8th Avenue S.W., Cal-
gary, Alberta at 2:30 P.M.

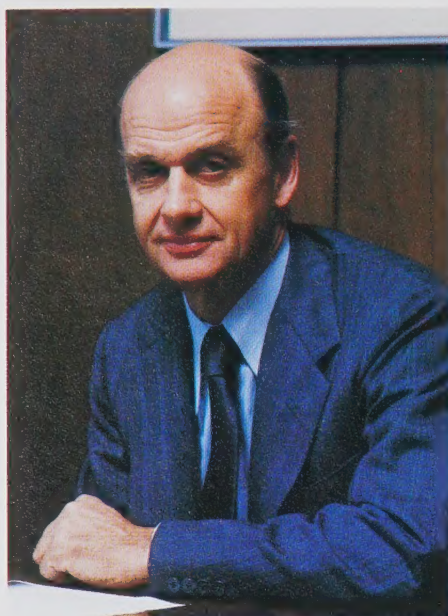


CORPORATE HIGHLIGHTS

	1979	1978
FINANCIAL		
Gross revenue	\$ 7,270,672	\$ 7,563,689
Funds provided from operations	3,362,833	3,790,372
Per share	.37	.44
Net earnings before extraordinary items ..	1,287,370	1,555,152
Per share	.14	.18
Net earnings	1,402,807	2,121,599
Per share	.16	.25
OPERATIONS		
Natural gas sales (MCF)	4,262,261	4,298,169
Daily average	11,677	11,776
Crude oil and condensate production (barrels)	170,358	169,546
Daily average	467	465
Proven reserves:		
Natural gas (MCF)	81,326,000	73,503,000
Crude oil and condensate (barrels) ...	1,956,142	1,954,219
Probable additional reserves:		
Natural gas (MCF)	18,425,000	18,155,000
Crude oil and condensate (barrels) ...	490,453	423,513
Land holdings including royalty interests		
Gross acres	846,704	938,267
Net acres	134,448	149,916
Wells drilled		
Gas	39	35
Oil	11	6



REPORT OF THE DIRECTORS TO THE SHAREHOLDERS



Total revenues in 1979 were \$7,270,672 compared to \$7,563,689 in 1978; funds provided from operations were \$3,362,833 compared to \$3,790,372 in 1978; and earnings before extraordinary items in 1979 were \$1,287,370 compared to \$1,555,152 in 1978. This flattening in income was due to weaker gas markets, increased operating costs, higher interest rates and, to a lesser degree, the sale of the Mayfair Hotel in mid-1978. The outlook for 1980, however, is very buoyant with cash flow expected to rise substantially due to increased gas sales from our 2 largest contract areas; the Peace River area contract which includes the Dunvegan and Belloy fields, and the Birch-Wavy contract which includes the Jarrow field.

In December, 1979, Paloma offered 1,200,000 common shares to the public from treasury. This offer, which was immediately subscribed, caused our shares to be distributed from coast to coast in Canada and increased the float from 1,165,178 to 2,365,178 shares. The proceeds, \$7,204,000, will be used for the expansion of the Company's oil and gas assets through exploration, development and acquisitions.

An attractive acquisition was made in late 1979 when Paloma acquired the Canadian properties of Bandera Resources Ltd. for \$1,454,000. These properties are all located in Alberta and comprise 170,240 gross acres (13,470 net acres) and, according to an independent engineer's appraisal, there are 6,713,000 MCF of proven and probable gas reserves.

Paloma, during the past year, participated in 64 wells which resulted in 39 gas discoveries, 11 oil discoveries and 14 dry holes. Our gas production averaged 11.7 MMCFD compared to 11.8 MMCFD in the previous year. Oil production averaged 467 barrels per day, the same as last year.

Gas marketing problems persisted through 1979 with some of our fields being shut-in for 4 months during the warm season. We received \$347,794 in pre-payments in 1979 in accordance with the "take or pay" provision of our gas contracts. The Company is relatively fortunate in having 70% of its gas reserves under contract and on stream. In December, 1979, the National Energy Board of Canada granted new gas export permits and we expect to start realizing the benefits of the increased exports in 1981.

Our 1979 activities resulted in new reserves of 12.2 BCF of gas and 316,000 barrels of oil and condensate. By comparison, we produced 4,262,261 MCF of gas and 170,358 barrels of oil and condensate in 1979. The Company's total proven and probable reserves at year end were 99,751,000 MCF of gas and 2,446,595 barrels of oil and condensate, representing a 23.4 year gas supply and a 14.5 year supply of oil and condensate at current production rates.

The Company has a 20.25% stake in an interesting new oil development taking place at Sibbald, Alberta, near the Saskatchewan

border where we now have 8 wells capable of producing 40 - 60 barrels per day in a 20 well pool. The oil gravity is 15° API. There will be more drilling and we expect to implement a waterflood scheme.

We are shifting our exploration from the highly drilled areas of east central Alberta to west central Alberta where the objectives are deeper and the reserves are indicated to be more rewarding. The recent Crown sale purchase of 5,280 acres for \$1.5 million (Company net interest 40%) in the Harmattan area, 100 kilometres northwest of Calgary, is an example of our new exploration emphasis.

Paloma develops 40 - 45% of its own prospects in Canada and, during the past year, operated 39% of the wells with average participation being 25%. In the U.S., we have a 21% interest in a 5 well oil exploration program on 12,000 acres located in northeast Montana, and in the Texas Panhandle we are participating for 10% in a 4 well oil and gas play on 12,800 acres. Development drilling continues in Cotton Valley, Louisiana where our interest is in the 2 - 4% range. We sold our leases in Arkansas at a profit and are having our Oklahoma lands evaluated by farmout drilling.

Two new officers of the Company were appointed at year end. Mr. John J. Nadurak, Manager of Operations for the past 4 years, was appointed Vice President, Operations and Mr. Brian J. Waters, Petroleum Engineer since September, 1977, was appointed Vice President, Engineering. The efforts of our dedicated staff of 11 employees have been greatly appreciated.

On behalf of the Board of Directors

John E. Stobart, President



REVIEW OF 1979 OPERATIONS

DRILLING

Paloma Petroleum Ltd. and its subsidiaries participated in the drilling of 64 wells in 1979. We were the operator for 25 or 39% of the wells and our average participation was 25%. This drilling activity resulted in 39 gas discoveries, 11 oil discoveries and 14 dry holes. Fifty-five wells were drilled in Alberta (37 east central, 2 central and 16 in the Peace River area); 2 wells were drilled in southern Saskatchewan and 7 wells were drilled in the United States (2 in Montana, 2 in northwest Texas and 3 in northwest Louisiana). Paloma's drilling record for the year is summarized as follows:

Wells	Gross	Net
Exploratory	23	7.8
Productive	14	4.6
Dry	9	3.2
Development	41	8.0
Productive	36	7.0
Dry	5	1.0

PRODUCTION

Natural Gas

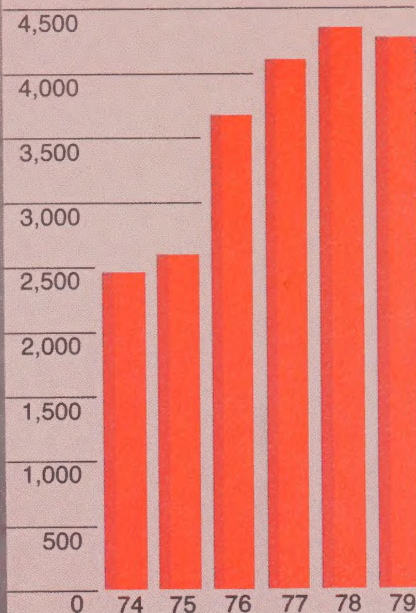
Gas sales decreased slightly to 4,262,261 thousand cubic feet in 1979 from 4,298,169 thousand cubic feet in 1978. Production was curtailed due to reduced market demand. Most areas were shut down a minimum of 3 - 4 months during the summer.

Oil and Condensate

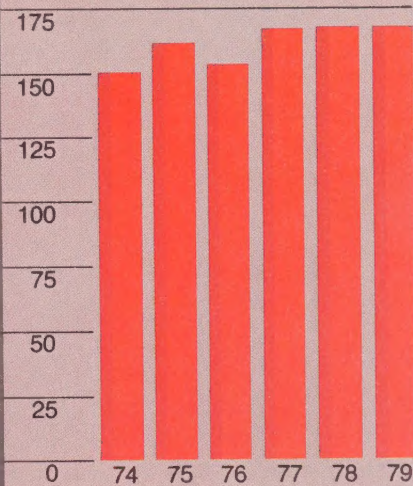
Crude oil and condensate production increased to 170,358 barrels in 1979 from 169,546 barrels in 1978.

PRODUCTION (Before Royalties)

NATURAL GAS MILLION CUBIC FEET



CRUDE OIL AND CONDENSATE THOUSAND BARRELS





RESERVES

The Company's total proved and probable reserves at year end were 99,751 million cubic feet of gas, representing a 23.4 year constant rate reserve life index, and 2,446,595 barrels of oil and condensate representing a 14.5 year constant rate reserve life index. Our 1979 drilling and acquisition program resulted in additions to reserves of 12,190 million cubic feet of natural gas and 316,022 barrels of crude oil and condensate.



PRICES AND MARKETS

Prices of petroleum and natural gas are determined by government; by the Provinces within their own borders, and by the Federal government for interprovincial and international trade. In March, 1980 the average wellhead price of gas in Alberta is \$2.60/MCF, the Toronto gate price is \$2.30/MCF, and the U.S. export price is \$4.47/MCF (U.S.). Oil sells at the wellhead in Alberta for \$14.75 on average, whereas imported oil comes into eastern Canada at around \$35.00/bbl. The Federal and Provincial governments agree that the Toronto gate price for natural gas should be approximately 85% of the cost of oil in the Toronto area on an energy equivalent basis. Future gas sales to the maritime provinces will likely be further discounted in price. Both levels of government agree that the domestic oil price must gradually rise to just under the international oil price. Still unresolved, as of March, 1980, is the schedule and amount of price increases required to close on the moving target of the international oil price. The Alberta government wants a more rapid price escalation than does the Federal government. Also still unresolved, and more important to the producers, is the net revenue they will receive after royalties and taxes to the Alberta government and taxes to the Federal government.

(Before Deduction of Royalties)
December 31, 1979

	Proved	Probable	Total
CRUDE OIL AND CONDENSATE (barrels)			
Province of Alberta . . .	1,538,381	485,734	2,024,115
Province of Saskatchewan	331,780	—	331,780
U.S.A.	85,981	4,719	90,700
Total	<u>1,956,142</u>	<u>490,453</u>	<u>2,446,595</u>

NATURAL GAS (MCF)

Province of Alberta:			
Peace River Area . .	41,406,000	12,315,000	53,721,000
Other	36,537,000	5,992,000	42,529,000
U.S.A.	3,383,000	118,000	3,501,000
Total	<u>81,326,000</u>	<u>18,425,000</u>	<u>99,751,000</u>

Paloma has committed most of its uncontracted gas reserves to Pan-Alberta Gas Ltd. and, although the National Energy Board will allow gas exports, the volumes are not sufficient to allow Pan-Alberta to proceed with the pre-building of the Alaskan Pipeline. Pan-Alberta has applied for additional volumes of gas to be exported and the hearing will be March 18, 1980. The United States' demand for additional Canadian natural gas is uncertain at the present time because of the latest increase in the export price to \$4.47 (U.S.) per MCF.



GAS SALES CONTRACTS

Paloma sells most of its natural gas under long term contracts to Alberta and Southern Gas Co. Ltd. and TransCanada PipeLines Limited while smaller volumes are purchased by Canadian-Montana Gas Company Limited, Canadian Western Natural Gas Company Limited and Pan-Alberta Gas Ltd. Approximately 70% of the Company's gas reserves are under contract and on stream. Thus the Company can expect to maintain at least its current level of revenue from the bulk of its reserves. Of the remaining reserves, 15% are uncontracted and 15% are contracted to Pan-Alberta Gas Ltd., subject to export approval.

Paloma has significant gas contracts covering 2 large areas of Alberta. The first area is covered by the Peace River #1 and #2 gas contracts with Alberta and Southern Gas Co. Ltd. covering 238 townships (5,483,520 acres) in northwest Alberta. These contracts expire in 1995 and provide for sales of gas reserves established within the area based on a reserve redetermination in each even-numbered year. Cur-

rent business conditions and lack of gas export markets limit the full realization of the potential of these contracts. The second area is governed by the Birch-Wavy Lake contract with TransCanada PipeLines Limited covering 192 townships (4,423,680 acres) in central Alberta and expiring in 1996. The contract provides for sales of gas reserves established within the contract area. There is a reserve redetermination each year and the Company has been able to and will continue to be able to contract additional gas reserves established in the area to TransCanada PipeLines Limited.

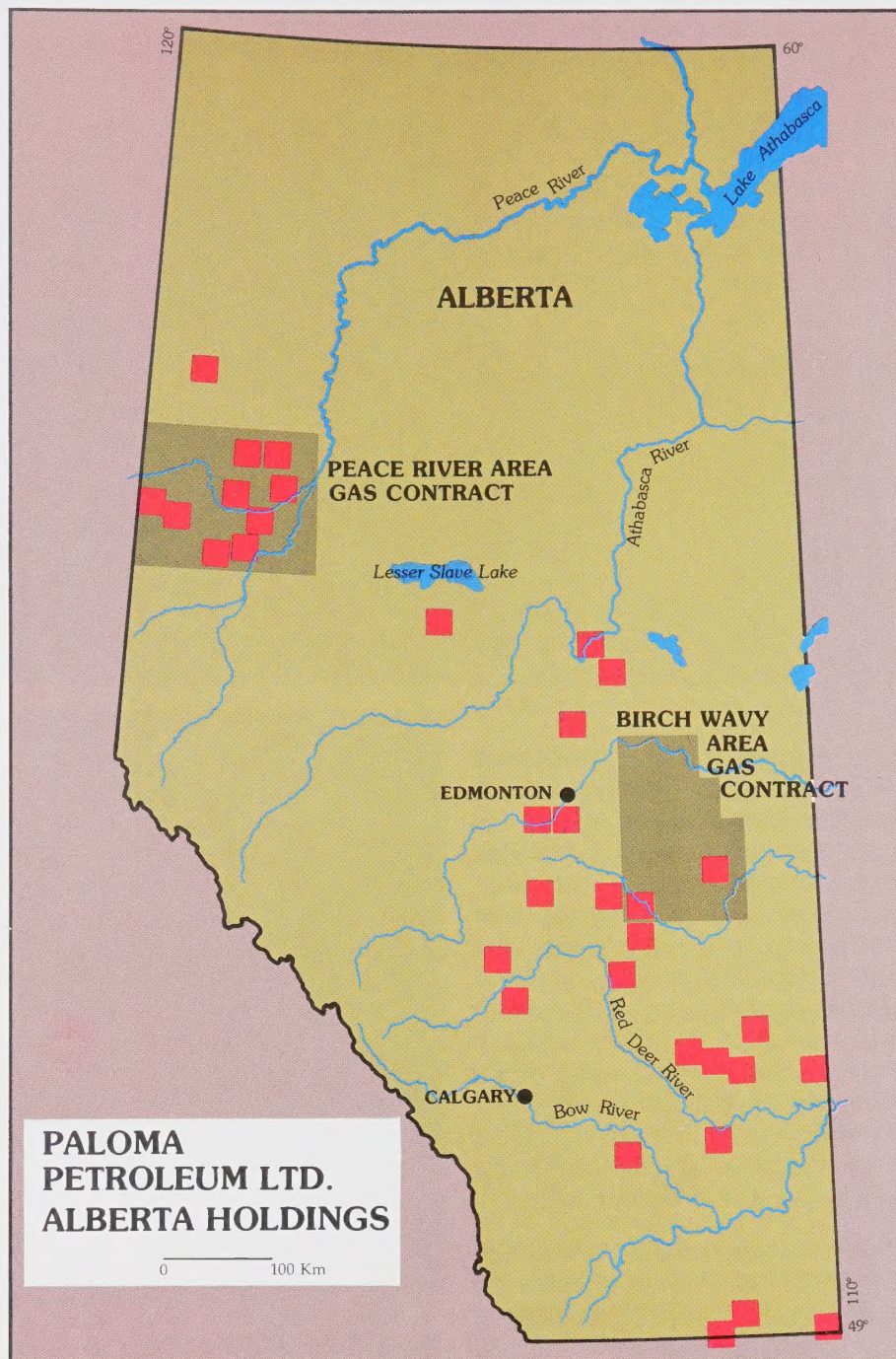


LAND HOLDINGS

December 31, 1979

	Total	
	Gross Acres	Net Acres
Alberta	801,108	128,836
British Columbia	1,282	738
Saskatchewan .	7,129	1,436
U.S.A.	37,185	3,438
	<u>846,704</u>	<u>134,448</u>

During the past year the Company sold 72,000 gross acres (24,222 net acres) in Arkansas and farmed out 4,187 net acres in Oklahoma.



DUNVEGAN

Paloma sold 1,810 million cubic feet of gas and 14,072 barrels of condensate from the Dunvegan Gas Unit in 1979. Dunvegan continues to be the Company's largest source of oil and gas revenue, contributing 35% in the past year. Marketing problems at Dunvegan continued in 1979 and Paloma again received funds through the "take-or-pay" provision of the contract. Paloma's interest in the Dunvegan Gas Unit is 4.3%.

Reservoir studies were conducted by the operator which indicated uneven depletion across the field; consequently, numerous wells have been recompleted and several additional infill wells drilled in order to deplete the field evenly. This has also helped in maintaining sales when the purchaser demands a larger nomination.

BELLOY

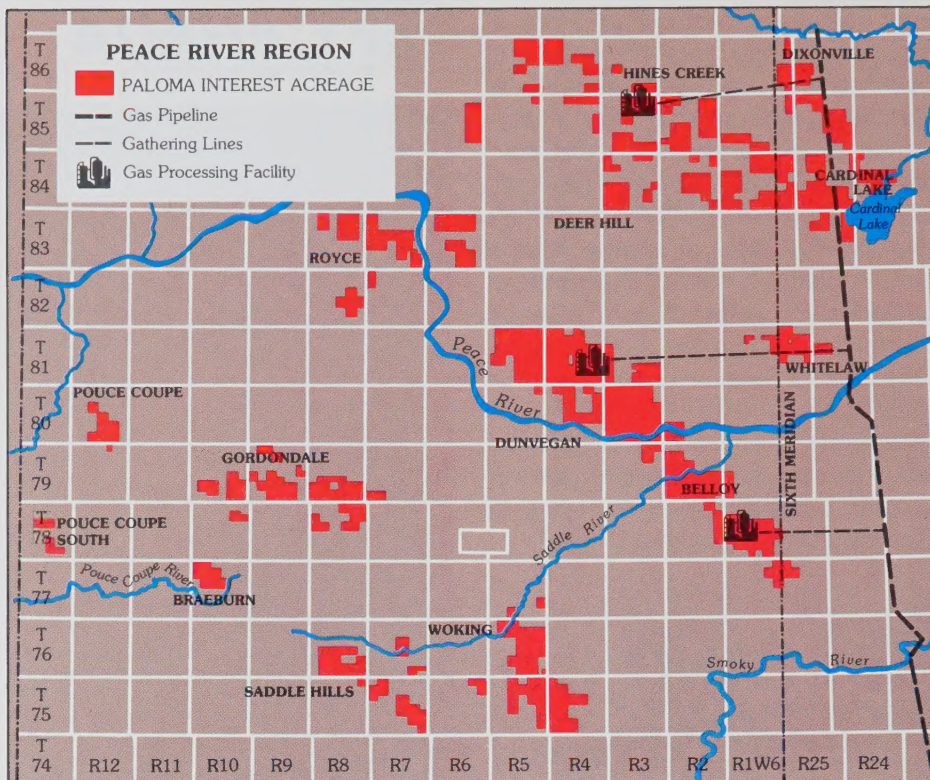
Our gas sales from Belloy decreased 3% during the year to 574 MMCF during 1979. This was due to low market demand during the first part of the year. During the last part of the year, sales were averaging 11.5 MMCFD — an increase of 30% from the previous year, which was due to recompletions and the addition of several new wells. Paloma's average interest in the Belloy production is 18%.

PEACE RIVER AREA

The Company has interests in 378,671 gross acres (19,914 net acres) in the Peace River area. This acreage is mostly undeveloped but it has good future exploration potential. Three exploratory wells were drilled on this acreage during 1979, resulting in 1 successful gas well. Additional drilling will be done in this area when gas markets improve.

Production averaged 4.5 MMCFD at Hines Creek where our net interest is 8.33%. At Woking, production averaged 3.1 MMCFD where our net interest is 8.33%. Sales in this area are expected to be increased considerably during the latter part of 1980 because of a new contract for this area. At Dixonville, where we hold an 8.33% interest, there are 3 shut-in gas wells. In addition, we have small interests in 2 shut-in gas wells at Cardinal Lake, 1 shut-in gas well at Whitelaw and 1 shut-in gas well at Gordondale.

Paloma joined the operator in pledging some of our shut-in gas reserves in the Peace River area to Pan-Alberta Gas Ltd. in support of their current export application to the National Energy Board.



WEST HOTCHKISS

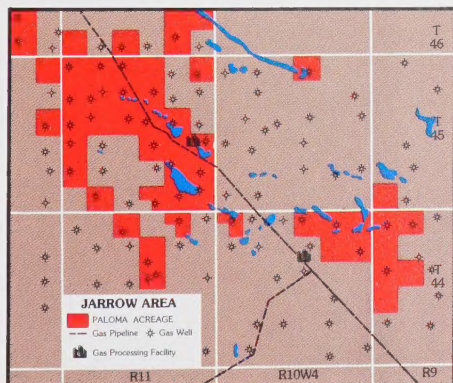
West Hotchkiss is 235 kilometres north of Grande Prairie, Alberta. Paloma has an interest in 6 shut-in gas wells and 16,700 gross acres (3,800 net acres) located 8 kilometres west of a major gas trunk line. The gas reserves are under contract to Pan-Alberta Gas Ltd. and production from the area awaits the decision by Pan-Alberta whether or not to proceed with the pre-build pipeline. The contract rate from the Paloma interest lands is 4.8 MMCFD.





EAST CENTRAL ALBERTA

The Company's production at Jarrow in 1979 was 901 MMCF, an 11% increase over the previous year. Due to upgrading of facilities, additional drilling and acquisitions through farmout and purchase, we expect that the Company's share of production in 1980 will increase 50% over 1979. We hold 33,280 gross acres (11,496 net acres) at Jarrow.



The Stanmore field, located 250 kilometres east northeast of Calgary produced an average 2.7 MMCF per day of which the Company's share is 1.25 MMCF per day. This field was shut-in for 4 months because of lack of gas market and was restricted during the remainder of the year due to cutbacks in gas nominations. Our land at Stanmore comprises 23,520 gross acres (7,227 net acres). There is scope at Stanmore for additional drilling, compression and line-looping when increased deliverability is required.

Over the past year, the Company has drilled 2 more wells for a total of 5 shut-in gas wells in the Oakland Lake area and has now acquired an interest in 3,840 gross acres (1,886 net acres). The 2 recent wells each encountered 2 productive Viking sands and 1 of the wells has been completed in the Glauconite zone. This is a rewarding exploratory area with these relatively shallow (1,100 metres) Cretaceous gas wells averaging 2 BCF of sales gas per section. The Company is pursuing farmin opportunities in the area.

In the Sunnynook area, 20 kilometres southwest of Stanmore, the Company has acquired 10,240 gross acres (3,447 net acres) and to date, there are 3 shut-in gas wells. The most recent well, 6-9-27-12W4M, drilled early in 1980 is an excellent Cretaceous gas well at 1,050 metres (3,400 feet). The Company is pursuing farmin opportunities in the area.

The Heathdale area, 20 kilometres east of Stanmore, remains shut-in with 7 gas wells and a number of locations to be drilled when there is a gas market. Oil shows in the Detrital zone in 2 wells were tested and found to be uneconomic. The Company has 28,320 gross acres (8,238 net acres) at Heathdale.

At Sibbald, just on the Alberta side of the Alberta-Saskatchewan border, Paloma completed 8 oil wells in the Glauconite zone at 875 metres (2,870 feet) depth. Paloma has a 20.25% working interest in the wells. The wells are capable of pumping 40 to 60 barrels of oil per day with the current allowable being 30 barrels of oil per day. The oil gravity is 15° API. Development drilling has resulted in 20 pool wells to date by all operators. The wells will

continue on primary production until all Crown lands in the area are leased and development drilling is complete, at which time a waterflood study will be undertaken. Initiation of water injection, should a waterflood scheme prove viable, will probably occur in 1981.

Also in the general area of Sibalbald (Acadia and Haven), Paloma has 1 gas well, tied in to a central gathering facility, producing 400 MCF per day, plus 4 shut-in gas wells and a number of prospective locations to be drilled when gas markets become available. The Company holds an interest in 16,640 gross acres (5,232 net acres) in this area.



WEST CENTRAL ALBERTA

Recent geological studies conducted in the Harmattan area resulted in the Company's acquisition by a Crown sale purchase of 5,280 gross acres (2,112 net acres). Currently, 35 miles of seismic data are being evaluated prior to the anticipated drilling of a 2,500 metre (8,100 feet) well during the summer of 1980. Objectives in this area are both oil and gas from Cretaceous and Mississippian age reservoirs. Additional geological and geophysical surveys and further land acquisition are planned for the area.

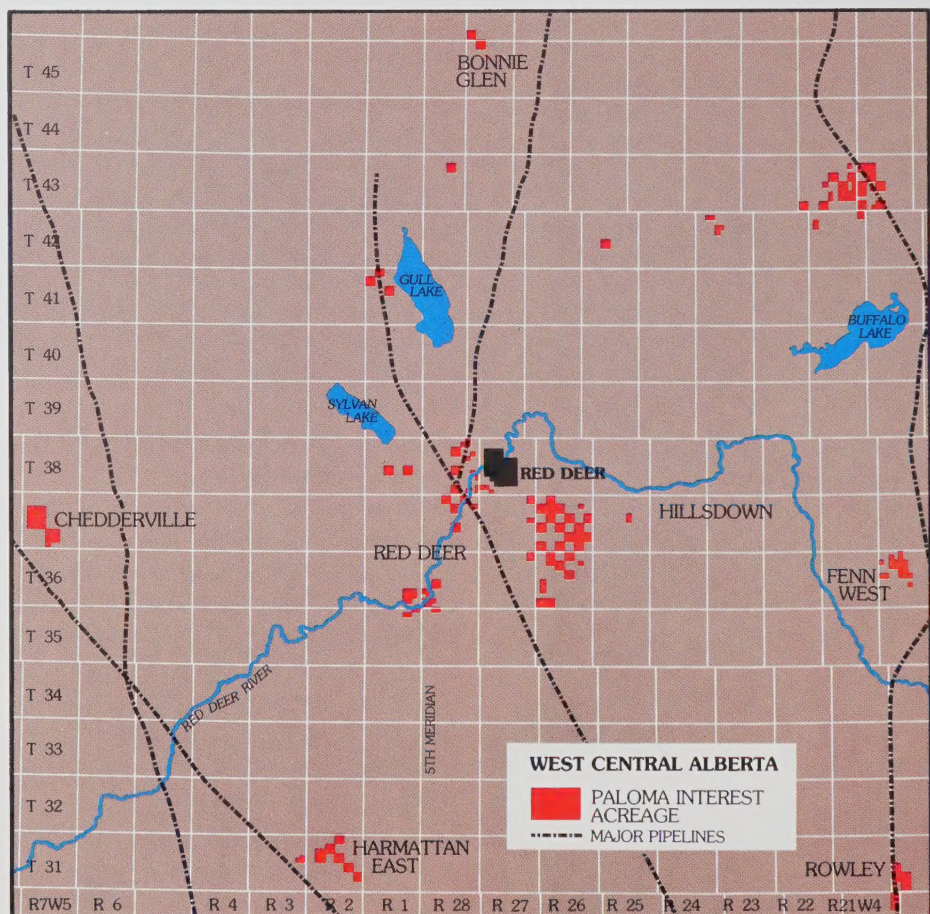
Chedderville is 20 kilometres south of Rocky Mountain House, Alberta. Paloma has an 11.25% interest in 2 D-3 gas wells and 5,120 gross acres (576 net acres). The wells are 3,620 metres (12,000 feet) deep and are located on the basis of seismic data. Additional wells will be drilled. The gas reserves are under contract to Pan-Alberta Gas Ltd. with a contract rate of 10 MMCFD. This will be one of the first areas from which Pan-Alberta will take gas

should they decide to proceed with the western leg of the pre-build pipeline.

At Bonnie Glen, Paloma participated in a farmin, earning an interest in 1,280 gross acres (192 net acres) with the drilling of a Cretaceous gas well to a depth of 1,670 metres (5,500 feet). The well is currently shut-in for market reasons and further drilling of the earned lands will be delayed until gas markets become available.

In the Red Deer area, the Company has acquired an interest in 10,204 gross acres (8,000 net acres). Approximately 40 kilometres (25 miles) of seismic data have also been acquired to assist in the geological evaluation of the lands. Based on these studies, 2 wells are planned for the summer of 1980 to test Cretaceous gas potential to a depth of 2,000 metres (6,500 feet).

In the Rowley area, located 20 kilometres north of Drumheller, the Company drilled 2 gas wells to develop gas reserves for sales beginning November 1, 1980 to Trans-Canada PipeLines Limited. The



Company has 3,840 gross acres (2,432 net acres) and 3 gas wells with gas reserves of 6 BCF in the Belly River, Viking and Pekisko zones at depths to 1,400 metres (4,600 feet). Sales will begin November 1, 1980 at 574 MCFD (388 MCFD our Company share).

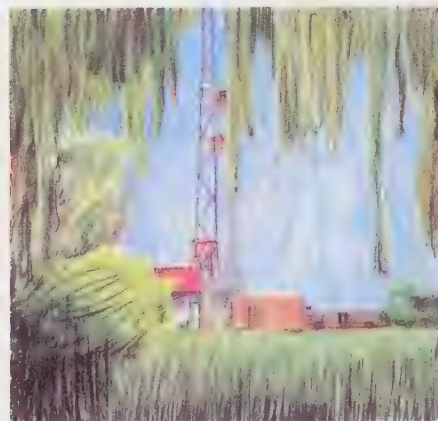
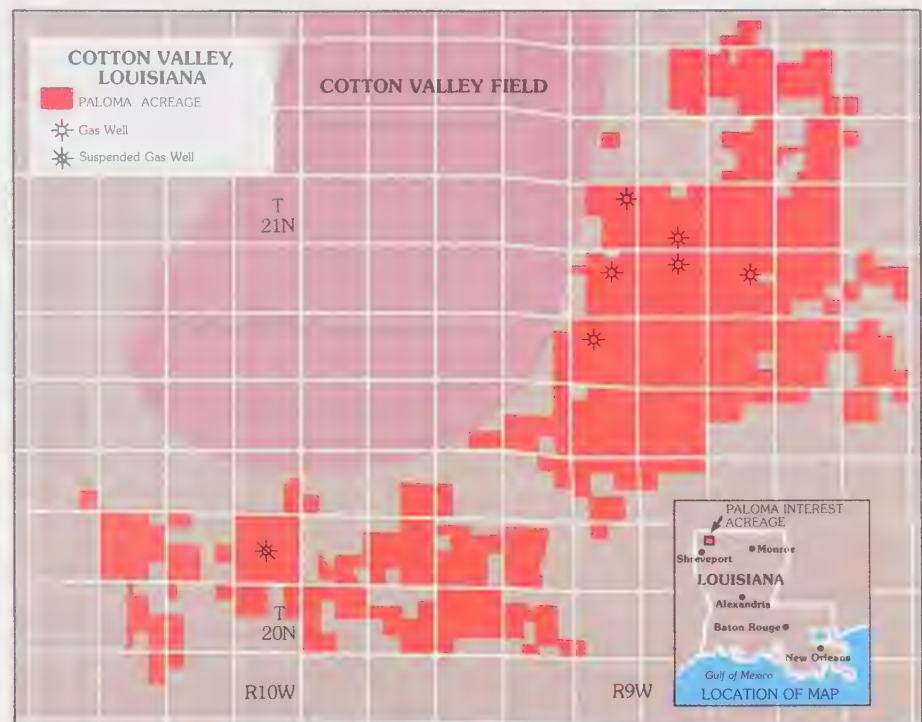
In the Fenn-West area, the Company has acquired an interest in 3,200 gross acres (784 net acres). A Cretaceous gas well was drilled on the lands in 1979 and is currently shut-in awaiting a gas market. Subsequent to drilling, a 13 mile seismic study was undertaken primarily to evaluate Devonian-Nisku oil potential, a zone productive to the east and west of the

Company's land holdings. A 1,750 metre (5,800 feet) well is planned for early 1980 to further delineate gas reserves and evaluate the oil potential of the lands.

At Hillsdown, a 2,000 metre (6,600 feet) well to the Devonian-Leduc is planned for the summer drilling season. The well will evaluate oil potential in the Nisku and gas potential in the Leduc formations. Nisku oil production occurs within one-half mile of the property. Paloma has a 100% working interest in 320 acres on this prospect.

LOUISIANA

The Company holds a 3.75% working interest plus a .94% overriding royalty in 22,000 acres on the eastern and southern flanks of the Cotton Valley field located 60 kilometres northeast of Shreveport, Louisiana. To date we have 6 completed wells, 4 on stream and 2 soon to be connected. The wells produce gas and minor condensate at about 1 MMCFD per well from the Smackover (Grey) Sand at 3,000 metres (11,000 feet) depth. Two additional wells are currently drilling. The gas is being sold at \$2.58 (U.S.) per MCF.



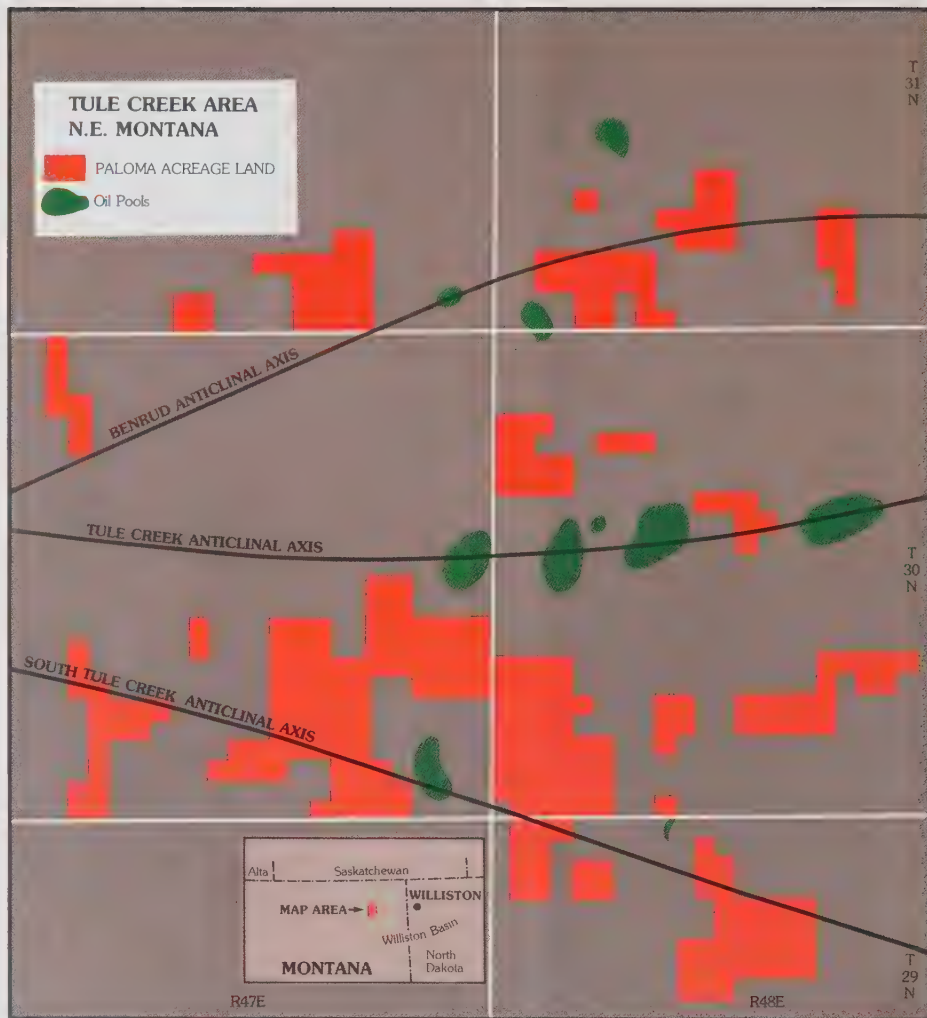
MONTANA

The Company is currently participating in a 5 well exploratory drilling program in the Tule Creek area of northeastern Montana. Upon completion of the program, Paloma will have earned an interest averaging 21% in 12,000 gross acres (2,520 net acres). The prospect is the result of detailed subsurface and geophysical analysis and is modeled after several small, but highly productive Devonian Nisku oil pools in the vicinity. The initial 3 wells of the program, drilled to an average depth of 2,225 metres (7,300 feet)

failed to discover commercial hydrocarbons and have been abandoned. The remaining 2 wells of the program are planned for the 1980 summer drilling season. A seismic program of approximately 40 kilometres (25 miles) has recently been shot to supplement existing data in support of the remainder of the drilling program. As a result of increased oil prices and the prolific nature of the Nisku reservoir, land acquisition and drilling activity have sharply escalated in recent months. The acreage spread to be earned by the drilling program will give the Company a strong position in future activity in the area.

TEXAS

At Roberts County, in the panhandle of northern Texas, the Company has a 10% interest in a 4 well exploratory drilling program. The prospect area lies on the southern flank of the Anadarko Basin where recent exploratory drilling has been concentrated on oil and gas objectives at average depths of 3,050 metres (10,000 feet) in the Pennsylvanian age Morrow Sands. The drilling of 3 wells to date has resulted in 1 oil well completed in the Squaw Belly zone of the Morrow; and 2 additional wells are cased and awaiting further evaluation of potential hydrocarbon zones. The 4th and final earning well of the program will be drilled subject to rig availability in the summer of 1980. Under the terms of the farmin agreement, it is necessary to prove the productive capability of a well prior to earning an interest in each farmout block. As a result, Paloma can ultimately earn an interest in 12,800 gross acres (640 net acres) if all 4 wells of the program are successful.



OTHER HOLDINGS

Compass Investments of Alberta Limited, a wholly owned subsidiary, derives revenue from oil and gas sales as well as from the operation of 6 cafeterias in Calgary and Edmonton and the leasing of a small shopping centre in Drayton Valley, Alberta. Revenue from the cafeterias and shopping centre provide a reliable source of income and contributes to financing the Company's main concern, which is the exploration and development of petroleum prospects.



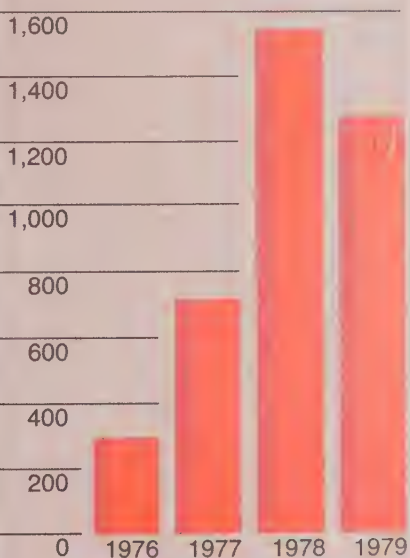
EARNINGS

In June, 1979 Paloma doubled the number of issued and outstanding common shares and in December, 1979 issued an additional 1,200,000 common shares to the public. For comparative purposes the 1978 per share amounts which follow have been restated to reflect the 1979 share split.

For the year ended December 31, 1979 net earnings amounted to \$1,402,807 (\$.16 per share) a decrease of 34 percent from \$2,121,599 (\$.25 per share) in 1978. Earnings before extraordinary items amounted to \$1,287,370 (\$.14 per share) a decrease of 17 percent from \$1,555,152 (\$.18 per share) for 1978.

EARNINGS

In Thousands of Dollars
(Before Extraordinary Items)



REVENUE

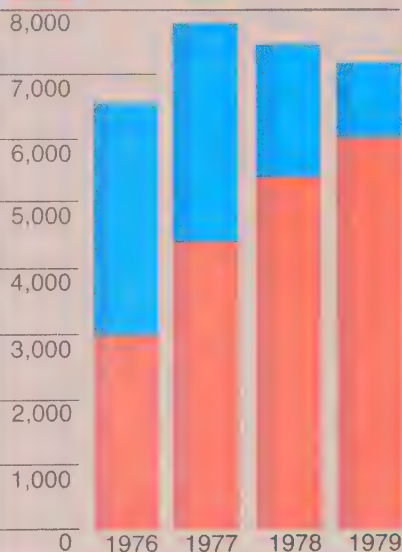
The Company's revenues for 1979 totalled \$7,270,672 down 4 percent from \$7,563,689 in 1978. Oil and gas sales increased 11 percent to \$6,020,998 from \$5,409,830 in the previous year. Although the sales volumes changed very little from 1978, higher wellhead prices resulted in the increase in revenues.

Real estate and other revenues, which last year included hotels, amounted to \$1,249,674 a decrease of 42 percent from 1978. This reduction in revenue reflected the sale of the Company's last major hotel in 1978.

SOURCES OF REVENUE

In Thousands of Dollars

OTHER (INCL. HOTEL AND REAL ESTATE)
OIL & GAS SALES



EXPENSES

Oil and gas production expenses of \$1,068,952 amounted to an increase of 56 percent from \$686,771 in 1978. The increase is the direct result of inflation, more wells on stream and the incurring of two years mineral tax expense during 1979.

Expenses of real estate and other operations declined 61 percent in 1979 to \$567,141 from \$1,453,545 in the previous year, the result of no hotel operations in 1979.

General and administrative expenses increased to \$869,073, up 28 percent from \$681,307 in 1978. Extraordinary costs pertaining to the share-split in 1979, settlement of a prior year's gas payment claim and professional fees pertaining to the Company's corporate financing contributed to the increase.

Higher interest rates in 1979 resulted in a 25 percent increase in interest expense for the year.

Depletion increased 36 percent in 1979 to \$1,098,895 from \$808,707 in 1978, reflecting greater capital expenditures on exploration, development and acquisitions.

CHANGES IN FINANCIAL POSITION

Funds provided from operations decreased in 1979 to \$3,362,833 down 11 percent from \$3,790,372 in 1978.

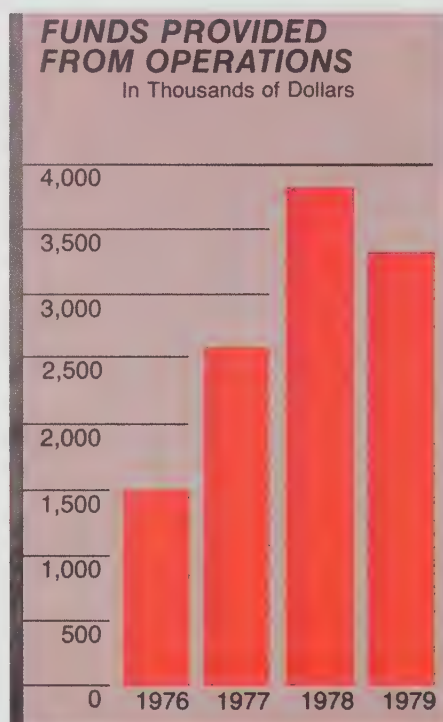
Working capital at December 31, 1979 amounted to \$8,128,349 compared to \$4,945,727 at December 31, 1978. Contributing to this increase were the following:

1) in December, 1979 the Company completed a successful common share underwriting. A total of 1,200,000 shares were issued to the public resulting in net proceeds to the Company, after expenses, of \$7,204,000.

2) take-or-pay receipts in 1979 amounted to \$347,794. This amount represents prepayments for natural gas not actually sold but for which the transmission companies were committed to purchase under the terms of our gas contracts.

Capital expenditures in 1979 amounted to \$7,907,562, up 88 percent from \$4,216,525 in 1978. The following is a break-down of the expenditures:

	1979	1978
Land	\$1,632,965	562,110
Exploration .	2,945,650	2,341,053
Development	2,412,942	478,748
Production facilities . .	916,005	834,614
	<u>\$7,907,562</u>	<u>4,216,525</u>



Included in the 1979 development expenditures is the acquisition of the Canadian properties of Bandera Resources Ltd. for \$1,454,000. Exploration and development of petroleum properties in Alberta continues to account for the major portion of the capital expenditures, however, the Company stepped up its expenditures in the United States in 1979.

OUTLOOK FOR 1980

We are optimistic about the future financial performance and potential growth of the Company. Paloma is looking for opportunities to enhance its cash flow and petroleum assets through exploration and acquisitions. Supported by the 1979 year end working capital of \$8,128,349 and the availability of all but one petroleum property for bank collateral, the Company is well prepared financially to pursue these objectives.

With an anticipated increase in gas sales and higher wellhead prices, the Company is projecting substantial increases in revenues, cash flow and net earnings in 1980.



AUDITORS' REPORT TO THE SHAREHOLDERS

We have examined the consolidated balance sheet of Paloma Petroleum Ltd. as at December 31, 1979 and the consolidated statements of earnings and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1979 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Canada
March 11, 1980

PEAT, MARWICK, MITCHELL & CO.
Chartered Accountants



CONSOLIDATED BALANCE SHEET

December 31, 1979

(with comparative figures for 1978)

Assets

	1979	1978
Current assets:		
Cash	\$ 8,478,054	3,694,536
Accounts receivable	3,013,327	2,403,182
Due from the Receiver General for Canada	718,556	—
Due from affiliated company	—	385,000
Prepaid expenses	46,502	36,267
Total current assets	12,256,439	6,518,985
Property, plant and equipment (Note 2)	28,872,189	21,250,905
Less accumulated depletion and depreciation	5,066,575	3,742,876
	23,805,614	17,508,029
Other assets (Note 3)	338,119	453,881
Goodwill, at cost less amortization of \$94,432 (1978 - \$74,221)	525,483	545,694
	<u>\$36,925,655</u>	<u>25,026,589</u>

Liabilities

	1979	1978
Current liabilities:		
Accounts payable and accrued liabilities	\$ 4,043,090	1,451,624
Current portion of long-term debt	85,000	121,634
Total current liabilities	4,128,090	1,573,258
Deferred revenue	873,637	525,843
Long-term debt (Note 4)	12,641,207	12,759,369
Deferred income taxes	3,202,147	2,694,352

Shareholders' Equity

Share capital (Note 5):		
Common shares without nominal or par value.	9,919,232	2,715,232
Contributed surplus	338,000	338,000
Retained earnings	5,823,342	4,420,535
	16,080,574	7,473,767
	<u>\$36,925,655</u>	<u>25,026,589</u>

On behalf of the Board:

 , Director

 , Director



CONSOLIDATED STATEMENT OF EARNINGS AND RETAINED EARNINGS

Year ended December 31, 1979
(with comparative figures for 1978)

	1979	1978
Revenues:		
Oil and gas net of royalties of \$3,627,597 (1978 - \$3,243,596)	\$6,020,998	5,409,830
Hotel and real estate	821,058	1,898,059
Other	428,616	255,800
	<u>7,270,672</u>	<u>7,563,689</u>
Expenses:		
Oil and gas production	1,068,952	686,771
Hotel and real estate	567,141	1,453,545
General and administrative	869,073	681,307
Interest on long-term debt	1,789,685	1,426,744
Depletion	1,098,895	808,707
Depreciation	263,570	342,437
Amortization	104,766	106,252
	<u>5,762,082</u>	<u>5,505,763</u>
Earnings before income taxes, minority interest and extraordinary items	1,508,590	2,057,926
Income taxes:		
Current	313,630	124,916
Deferred	623,232	914,937
Province of Alberta Royalty Tax Credit	(715,642)	(599,966)
	<u>221,220</u>	<u>439,887</u>
Earnings before minority interest and extraordinary items	1,287,370	1,618,039
Minority interest in earnings of subsidiaries	—	62,887
Earnings before extraordinary items	1,287,370	1,555,152
Extraordinary items (Note 6)	115,437	566,447
Net earnings	1,402,807	2,121,599
Retained earnings at beginning of year	4,420,535	2,298,936
Retained earnings at end of year	<u>\$5,823,342</u>	<u>4,420,535</u>
Earnings per share:		
Before extraordinary items	\$ 0.14	0.18
Extraordinary items	0.02	0.07
	<u>\$ 0.16</u>	<u>0.25</u>



CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

Year ended December 31, 1979
(with comparative figures for 1978)

	1979	1978
Funds provided from:		
Operations	\$ 3,362,833	3,790,372
Proceeds on sale of property, plant and equipment	262,512	4,357,654
Increase in long-term debt	—	661,889
Issue of share capital	7,204,000	1,206,450
Reduction in other assets	31,207	18,910
Deferred revenue	347,794	525,843
	<u>11,208,346</u>	<u>10,561,118</u>
Funds applied to:		
Purchase of property, plant and equipment	7,907,562	4,216,525
Reduction in long-term debt	118,162	—
Net assets acquired on business combination	—	1,206,450
	<u>8,025,724</u>	<u>5,422,975</u>
Increase in working capital	3,182,622	5,138,143
Working capital (deficiency) at beginning of year	4,945,727	(192,416)
Working capital at end of year	<u>\$ 8,128,349</u>	<u>4,945,727</u>



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1979

1. Summary of significant accounting policies:

a) Principles of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned.

b) Property, plant and equipment:

The Company follows the full cost method of accounting for oil and gas properties whereby all costs relating to the exploration and development of oil and gas reserves are capitalized. Such costs include those related to lease acquisitions, geological and geophysical activities, carrying charges of non-producing properties, drilling both productive and non-productive wells and overhead related to exploration. Proceeds from minor property sales are reflected as a reduction of the total capitalized costs; gains or losses on significant property sales are recognized in the statement of earnings.

Depletion of oil and natural gas properties and depreciation of production and other equipment are calculated on the composite unit-of-production method, based on estimated proven reserves, as determined by company engineers. Depreciation of other assets is calculated on a straight-line basis at the following rates:

Building	4% - 5%
Equipment	5% - 10%

c) Other assets:

Video tapes are being amortized on a straight-line basis over seven years.

Financing costs are being amortized on a straight-line basis over six years.

d) Goodwill:

Goodwill, is being amortized on a straight-line basis over thirty years.

e) Joint interest operations:

Substantially all of the Company's oil and gas exploration and production activities are conducted jointly with others and accordingly the accounts reflect only the Company's proportionate interest in such activities.

2. Property, plant and equipment:

	1979	1978
Oil and gas:		
Oil and gas properties, at cost	\$ 23,246,923	16,406,519
Less accumulated depletion	3,938,578	2,839,684
	<u>19,308,345</u>	<u>13,566,835</u>
Production and other equipment, at cost	4,477,078	3,681,027
Less accumulated depreciation	983,078	806,606
	<u>3,494,000</u>	<u>2,874,421</u>
	<u>22,802,345</u>	<u>16,441,256</u>
Other:		
Land, buildings, equipment and improvements, at cost	1,148,188	1,163,359
Less accumulated depreciation	144,919	96,586
	<u>1,003,269</u>	<u>1,066,773</u>
	<u>\$ 23,805,614</u>	<u>17,508,029</u>

3. Other assets:

	1979	1978
Agreements for sale receivable, net of current portion	\$ 25,907	57,950
Video tapes, at cost less amortization of \$248,837 (1978 — \$186,627)	186,629	248,839
Drilling and other deposits, at cost	51,938	51,826
Sundry investments	28,952	28,227
Financing costs, at cost less amortization of \$89,383 (1978 — \$67,037)	44,693	67,039
	<u>\$ 338,119</u>	<u>453,881</u>

4. Long-term debt:

	1979	1978
Term bank loans, secured by certain petroleum and natural gas properties	\$ 12,432,540	12,517,287
First mortgages and agreements for sale	—	70,049
Note payable on video tapes, unsecured, non- interest bearing, due 1981	293,667	293,667
	<u>12,726,207</u>	<u>12,881,003</u>
Deduct current portion of long-term debt	85,000	121,634
	<u>\$ 12,641,207</u>	<u>12,759,369</u>

On the \$12,000,000 term bank loan, equal monthly repayments, blended as to interest and principal, commence in 1982 with the final instalment due in 1990. The remaining term bank loan is repayable by monthly instalments of interest and principal of \$12,000. Interest on both loans is calculated at 1½% over the banks' prime lending rates.

5. Share capital:

	Number of Shares	Consideration
a)		
Balance December 31, 1978	4,490,224	\$ 2,715,232
Issued on share split	4,490,224	—
Issued pursuant to public offering net of underwriting commission and expenses of the issue of \$558,000 less applicable income taxes of \$262,000	1,200,000	7,204,000
Balance December 31, 1979	<u>10,180,448</u>	<u>\$ 9,919,232</u>

- b) During the year, the authorized share capital of the Company was increased by 8,000,000 common shares to 15,000,000 common shares without nominal or par value to be issued for a maximum consideration of \$35,000,000.
- c) During the year the Company reserved for issue 444,500 common shares pursuant to an employee stock option plan. Under the plan, options have been granted with respect to 350,000 shares, exercisable at \$3.65 per share. The options are exercisable as to 20% each year from the date of issue on a cumulative basis and expire in June 1989.

6. Extraordinary items:

	<u>1979</u>	<u>1978</u>
Reduction of deferred income taxes resulting from application of drilling and exploration expenses by certain subsidiaries	\$115,437	100,000
Gain on sale of hotels and real estate, net of applicable income taxes of \$295,000 and minority interest of \$123,292	—	466,447
	<u>\$115,437</u>	<u>566,447</u>

7. Earnings per share:

Earnings per share have been calculated using the weighted average number of common shares, after giving effect to share subdivisions, outstanding during the period. Had all of the employee stock options been exercised, there would have been no dilutive effect on earnings per share.

8. Remuneration:

The aggregate remuneration paid to directors and senior officers during the year amounted to \$273,150 (1978 — \$253,616).

